

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
RICHMOND DELI & BAGELS, INC.,	:	ORDER
AND NABILA HUSSAIN	:	DTA NOS. 823244 AND
	:	823250
for Revision of Determinations or for Refund of Sales	:	
and Use Taxes under Articles 28 and 29 of the Tax Law	:	
for the Period June 1, 2005 through February 29, 2008.	:	

Petitioners, Richmond Deli & Bagels, Inc., and Nabila Hussain, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 2005 through February 29, 2008.

On July 5, 2012, Administrative Law Judge Catherine M. Bennett issued a determination that granted the petitions of Richmond Deli & Bagels, Inc., and Nabila Hussain as to the sales and use tax assessed, and cancelled the Notice of Determination issued to Richmond Deli & Bagels dated September 2, 2008, and the Notice of Determination issued to Nabila Hussain dated September 19, 2008.

Petitioners, appearing by Maynard, O'Connor, Smith & Catalinotto, LLP (Aaron F. Carbone, Esq., of Counsel), brought an application for costs under Tax Law § 3030 on August 29, 2012. The Division of Taxation, appearing by Mark F. Volk, Esq. (Lori P. Antolick, Esq., of counsel), filed an affirmation in opposition to the application by its due date of September 28, 2012, which date began the 90-day period for issuance of this order.

Based upon petitioners' application for costs, the Division's affirmation in opposition, the determination issued July 5, 2012, and all pleadings and proceedings had herein, Catherine M. Bennett, Administrative Law Judge, renders the following order.

ISSUE

Whether petitioners are entitled to an award of costs pursuant to Tax Law § 3030.

FINDINGS OF FACT

1. Petitioners, Richmond Deli & Bagels, Inc., (Richmond Deli) and Nabila Hussain, operate a deli grocery store in Staten Island, New York, selling soda, beer, cigarettes, sandwiches, prepared foods, coffee, detergent and other similar grocery items. Richmond Deli is a subchapter S corporation and Nabila Hussain is a 100% shareholder and a responsible officer of the corporation. Ms. Hussain's status as a responsible officer of Richmond Deli is conceded.

2. Richmond Deli was in operation until approximately June 12, 2008, when it was sold pursuant to a bulk sale to Annadale Gourmet, Inc. (Annadale).

3. The Division of Taxation (Division), notified petitioners that their sales and use tax records had been selected for a field audit that would begin on June 26, 2008, and would cover the eleven quarterly sales tax periods from June 1, 2005 through February 29, 2008. Petitioners were asked to have all books and records pertaining to the sales and use tax liability available for the audit, and attached to the Division's correspondence was a Records Requested List that set forth in detail all of the books and records that were required to be made available.

4. The records provided to the Division at its first meeting with petitioners' representative on August 1, 2008 included: Richmond Deli's federal income tax return for 2006; a portion of the sales tax returns covering the period December 1, 2006 through May 31, 2008; partial general ledgers for years 2006 and 2007; a balance sheet as well as revenue, expenses and retained

earnings for 2005 through 2007; a purchase agreement between petitioners and Annadale; bank statements for the entire audit period; cancelled checks for the period December 1, 2007 through February 29, 2008; purchase invoices from December 2006 through February 2008; a loan summary and a chart of accounts. No cash register tapes were produced for the audit period, the federal income tax returns for 2005 and 2007 were missing, and the purchase records in addition to the general ledger for the audit period were not complete in their submission.

5. Upon review of petitioners' available records, the Division determined petitioners' records to be inadequate. The basis for the determination in large part was due to the fact that when an attempt was made to reconcile the bank statements for the audit period to the gross sales reported by Richmond Deli, there were more than \$2 million worth of reported sales not deposited into the corporation's bank account. Petitioners' explanation of the discrepancy was that the funds were used to make purchases of various products by cash. Although when asked to provide those purchase records, petitioner requested additional time to obtain them, the records were ultimately never produced. The Division also based its determination of the inadequacy of petitioners' records on the facts that there were no cash register tapes for the audit period and the records did not allow for the transactions to be traced back to the original source or forward to a final total. The auditor also noted that bank deposits were not in substantial agreement with the books and records or the sales tax returns for the same time frame, and the daily receipts were not reconciled to the sales documents and deposits.

6. The Division issued a Notice of Determination dated September 2, 2008 to Richmond Deli, assessing additional sales and use taxes in the amount of \$247,119.71, plus penalty and interest, for the period June 1, 2008 through February 29, 2008. The Division issued a Notice of Determination to Nabila Hussain dated September 19, 2008, which assessed tax in the same

amount plus penalty and interest for the same period. The notice advised Ms. Hussain that it was being issued because she was an officer or responsible person of Richmond Deli.

7. After a determination that petitioners' books and records were inadequate, having received no further records from petitioners, the Division calculated additional tax due in the amount of \$247,119.71, based upon an indirect audit methodology that relied upon prepaid cigarette credits claimed by Richmond Deli on its returns for the audit period. The auditors accepted as accurate the amount of the cigarette credits claimed on petitioners' returns. These credits were used by the auditors to determine how many packs of cigarettes were sold during the audit period. Using a minimum retail cigarette selling price, the auditors calculated petitioners' minimum cigarette retail sales. Using this method they determined that cigarette sales represented an average of 22% of petitioners' reported gross sales. Believing this ratio to be high due to suspected underreporting of gross sales, the Division chose a ratio of 15% to calculate gross sales. Although it first appeared as though the 15% was based upon a Division investigator's visit to Richmond Deli, it was later revealed that the investigator had observed the successor owner's operations (Annadale). There was no basis for the comparison of the two businesses other than location, and no specifics as to the investigator's observation were provided. In addition, the Division conceded it did not have documented substantiation for the 15% estimate and conceded that the use of an estimate in an indirect audit method without such documentation, on the basis of the auditor's prior experience alone, without more, was an error.

8. The Division revealed that it had performed a similar cigarette sales credit analysis in two other cases to estimate gross sales of a grocery store and deli where the businesses did not have adequate books and records to independently determine sales. In those cases 14% and 10%,

respectively, were the ratios used, though they arose in the context of settlement negotiations, at the suggestion of the representatives in those cases. No information was provided to determine how similar or different those businesses were when compared to Richmond Deli. Petitioners did not agree with this methodology and did not provide the Division with a percentage that they believed was more accurate. Other audit methods were dismissed by the Division due to petitioners' incomplete records.

9. A hearing before an administrative law judge was held on April 27 and 28, 2011, at which time petitioners presented the testimony of their CPA, John Shall, Sr., who proffered his opinion that the indirect audit methodology was erroneous and the results incapable of being reasonably accurate. The basis for Mr. Shall's opinion and report was his firsthand knowledge of petitioners' business, his review of the Division's files pertaining to petitioners, a review of applicable laws and regulations, and an observation test and mark-up analysis that he conducted of Annadale approximately two and a half years after the end of petitioners' audit period. He took the information he gathered from the observation of Annadale and applied it to the information reported on Richmond Deli's sales tax returns for the period in issue, in order to determine whether a material variance existed between what was observed and what was reported on those returns. Mr. Shall concluded that the results of his mark-up test were normal and that Richmond Deli's reported sales tax amounts were within a regularly accepted margin of error.

Petitioner Nabila Hussain did not testify at the hearing.

10. On July 5, 2012, a determination was issued by Catherine M. Bennett, Administrative Law Judge. Having determined that petitioners did not provide sufficient sales records for the audit period to enable the auditors, the determination found that the Division was within its rights to resort to an estimated audit methodology to determine if petitioners had properly remitted sales

and uses taxes for the audit period. The only questions presented in this matter were whether petitioners had established that the audit methodology employed, based upon cigarette tax credits claimed and the sales reported, was unreasonable, and whether the amount of tax assessed as the result of the application of the method used was erroneous. The determination cited *Matter of Shree Purshottam Corporation* (Tax Appeals Tribunal, May 27, 2010), in which the sales records were also unreliable, and the Division used the prepaid cigarette tax credits to calculate the number of packs of cigarettes sold, forming a basis for estimating sales. The determination contained the following discussion:

In that case, the Division determined that a relationship existed between the number of packs of cigarettes sold and the actual sales. The basis for the methodology in *Shree Purshottam* was a detailed well-documented observation test, and such test allowed the Division to establish a relationship between the taxable sales and the cigarette sales. These facts, in addition to that petitioner's failure to show that the audit results were inaccurate, supported the conclusion that the methodology in *Shree Purshottam* was reasonable.

In and of itself, the audit methodology based upon cigarette credits claimed is not improper, though it may not be the most desirable method or provide the most reliable correlation to sales. However, its use in *Shree Purshottam* can be distinguished from petitioners' case. Most importantly, in this case, there is no similar basis to establish a percentage relationship between cigarette sales and total sales. No observation test of petitioners' business was conducted. The percentage that was used in this case, defining the relationship between cigarette sales and total sales, was drawn from neither an observation of petitioner's business, nor an observation of a similar establishment. Instead, the Division's auditors defined the percentage in this case on the basis of settlement negotiations of cases where Mr. Mahase had also suggested the use of the cigarette tax methodology. Percentages used in calculations of sales based upon settlement negotiations is not the equivalent of providing petitioners with an audit methodology to challenge or prove unreasonable. The auditors were not able to describe the rationale behind the percentages because one simply does not exist where the basis for their existence is settlement of a case. The Tax Appeals Tribunal has stated clearly that the Division must be able to respond meaningfully to petitioners' inquiries as to the nature of the audit performed (*Matter of Basileo; Matter of Fokos Lounge*). The Division simply could not do so, placing petitioners at a severe disadvantage. Even if the percentages relied upon by the Division had some correlation to the sales of those other audited companies, no

information about the similarities or differences between Richmond Deli and the other companies was provided.

* * *

The auditors admitted having no documentation for their estimate in this case, and also conceded that they could not support audit results on prior audit experience alone. Accordingly, the Division has failed in every regard to show that the methodology had a rational basis.

11. All assessments in this case were cancelled based on a determination that they were derived from a method lacking a rational basis and the results were thus erroneous, and the determination concluded as follows:

In summary, it is undisputed that petitioners did not maintain and, therefore, produce for audit, the books and records necessary to perform a detailed audit. Case law holds that, as a general proposition, any imprecision in the results of an audit arising by reason of a taxpayer's own failure to maintain adequate and accurate records of all of its sales as required by Tax Law § 1135(a)(1) must be borne by that taxpayer (*Matter of Meyer v. State Tax Commn.*; *Matter of Markowitz v. State Tax Commn.*). This was not mere imprecision, however. The rational basis required to be shown of the methodology simply could not be established, since the 15% estimate, from which all calculations flowed, was not verifiable, not substantiated and simply not rationally connected to the operations of petitioners' business. By clear and convincing evidence, petitioners have shown that the audit method employed was unreasonable and lacks any rational basis.

12. Petitioners' August 29, 2012 application for costs seeks an award of costs in the amount of \$60,417.30, consisting specifically of the following items:

- a) \$40,128.50 for attorney's fees, at hourly rates ranging from \$150.00 to \$250.00;
- b) \$2,221.30 for administrative fees and disbursements; and
- c) \$18,067.50 for accounting and expert witness services.

13. Accompanying petitioners' application for costs were voluminous and detailed itemized statements of each of the attorney's and expert services listed, setting forth the actual time expended and the rate at which their fees and other expenses were computed. The

disbursements were included in the attorney's statements of services, and one invoice in the amount of \$1,379.50 for transcription services was provided.

14. Also accompanying petitioners' application for costs was the affidavit of petitioners' representative, Aaron F. Carbone, Esq., who set forth the procedural history of this matter and presented a request that the full cost of legal services be reimbursed on the basis that Tax Law § 3030 was enacted in 1997, and there are a limited number of attorneys sufficiently versed in practice and procedures of litigating a sales tax matter in a hearing before the Division of Tax Appeals.

SUMMARY OF THE PARTIES' POSITIONS

15. Petitioners maintain that they are the prevailing parties and should be awarded the full amount of the costs they are seeking.

16. In opposition to petitioners' application, the Division maintains that petitioners' application for costs should be denied because the Division's position in this matter was substantially justified, that petitioners have failed to establish that their net worth did not exceed the statutory limits, that petitioners have failed to establish their litigation and administrative costs with sufficient detail, and that the costs sought to be recovered are unauthorized and unreasonable.

CONCLUSIONS OF LAW

A. Tax Law § 3030(a) provides, generally, as follows:

In any administrative or court proceeding which is brought by or against the commissioner in connection with the determination, collection, or refund of any tax, the prevailing party may be awarded a judgment or settlement for:

(1) reasonable administrative costs incurred in connection with such administrative proceeding within the department, and

(2) reasonable litigation costs incurred in connection with such court proceeding.

Reasonable administrative costs include reasonable fees paid in connection with the administrative proceeding, but incurred after the issuance of the notice or other document giving rise to the taxpayer's right to a hearing (Tax Law § 3030[c][2][B]). The statute also provides that fees for the services of an individual who is authorized to practice before the Division of Tax Appeals are treated as fees for the services of an attorney (Tax Law § 3030[c][3]).

B. A prevailing party is defined by the statute as follows:

any party in any proceeding to which [Tax Law § 3030(a)] applies (other than the commissioner or any creditor of the taxpayer involved):

(i) who (I) has substantially prevailed with respect to the amount in controversy, or (II) has substantially prevailed with respect to the most significant issue or set of issues presented, and

(ii) who (I) within thirty days of final judgment in the action, submits to the court an application for fees and other expenses which shows that the party is a prevailing party and is eligible to receive an award under this section, and the amount sought, including an itemized statement from an attorney or expert witness representing or appearing in behalf of the party stating the actual time expended and the rate at which fees and other expenses were computed . . . and (II) is an individual whose net worth did not exceed two million dollars at the time the civil action was filed . . . , or any . . . corporation . . . the net worth of which did not exceed seven million dollars at the time the civil action was filed

(B) Exception if the commissioner establishes that the commissioner's position was substantially justified.

(i) General rule. A party shall not be treated as the prevailing party in a proceeding to which subdivision (a) of this section applies if the commissioner establishes that the position of the commissioner in the proceeding was substantially justified.

(ii) Burden of proof. The commissioner shall have the burden of proof of establishing that the commissioner's position in a proceeding referred to in subdivision (a) of this section was substantially justified, in which event, a party shall not be treated as a prevailing party.

(iii) Presumption. For purposes of clause (i) of this subparagraph, the position of the commissioner shall be presumed not to be substantially justified if the department, inter alia, did not follow its applicable published guidance in the administrative proceeding. Such presumption may be rebutted.

* * *

(C) Determination as to prevailing party. Any determination under this paragraph as to whether a party is a prevailing party shall be made by agreement of the parties or (i) in the case where the final determination with respect to tax is made at the administrative level, by the division of tax appeals, or (ii) in the case where such final determination is made by a court, the court (Tax Law § 3030[c][5]).

C. Petitioners succeeded, based upon their production of testimony and documentary evidence at hearing, in meeting their burden of proving by clear and convincing evidence that the result of the sales tax audit was erroneous and that the audit method was unreasonable. Consequently, the notices of determination for sales tax liability were canceled in their entirety. Notwithstanding this result, however, petitioners' cost application fails on a number of grounds.

D. Petitioners were not the prevailing party within the meaning and intent of Tax Law § 3030 because the Division was substantially justified in issuing the notices based upon the information in its possession at the time the notices were issued.

Tax Law § 3030 is clearly modeled after Internal Revenue Code § 7430. It is proper, therefore, to use Federal cases for guidance in analyzing this state law (*see Matter of Levin v. Gallman*, 42 NY2d 32, 396 NYS2d 623 [1977]; *Matter of Sener*, Tax Appeals Tribunal, May 6, 1988). A position is substantially justified if it has a reasonable basis in both fact and law (*see Information Resources, Inc. v. United States*, 996 F2d 780, 785, 93-2 US Tax Cas ¶ 50,519 [1993]), with such determination properly based "on all the facts and circumstances surrounding the case, not solely upon the final outcome" (*Phillips v. Commissioner*, 851 F2d 1492, 1499, 88-

2 US Tax Cas ¶ 9431 [1988]; *Heasley v. Commissioner*, 967 F2d 116, 120, 92 US Tax Cas ¶ 50,412 [1992]). The fact that the notices were cancelled by the administrative law judge is a factor to be considered (*Heasley*). However, this outcome does not preclude a finding that the Division's position was substantially justified at the time the notices were issued, since the finding must be made in view of what the Division knew at the time its position was taken (Tax Law § 3030[c][8][B]; *see DeVenney v. Commissioner*, 85 TC 927, 930 [1985]).

The Tax Court in *Oak Knoll Cellar v. Comm. of Internal Revenue* (68 TCM 412 [1994]) reviewed the legislative history of Internal Revenue Code § 7430 pertaining to the guidelines for determining whether the conduct of the government was unreasonable, as follows:

The committee intends that the determination by the court on this issue [of reasonableness] is to be made on the basis of the facts and legal precedents relating to the case as revealed in the record. Other factors the committee believes might be taken into account in making this determination include, (1) whether the government used the costs and expenses of litigation against its position to extract concessions from the taxpayer that were not justified under the circumstances of the case, (2) whether the government pursued the litigation against the taxpayer for purposes of harassment or embarrassment, or out of political motivation, and (3) such other factors as the court finds relevant (*HR Rep 404, 97th Cong*, at 12 [1981]).

E. There is no dispute that petitioners in this case did not maintain books and records sufficient for the Division to perform a detailed audit and verify that sales had been properly reported. In fact, when an attempt was made to reconcile the bank statements for the audit period to the gross sales reported by Richmond Deli, there were more than \$2 million worth of reported sales not deposited into the corporation's bank account. Petitioners' explanation of the discrepancy was that the funds were used to make cash purchases for the business. However, no supporting documentation was produced. In addition, there were no cash register tapes for the audit period, and the records did not allow for the transactions to be traced back to the original source or forward

to a final total. Bank deposits did not agree with the books and records or the sales tax returns and the daily receipts were not reconciled to the sales documents and deposits. Because of the failure by petitioners to maintain sufficient records, the Division was clearly entitled to resort to an estimated methodology to determine whether petitioners owed additional sales tax. Petitioners argued, however, that the Division should have conducted an observation test or a markup test rather than resort to using petitioners' cigarette tax credits. The Tax Appeals Tribunal has held that eliminating the feasibility of alternate estimation audit methodologies is not a mandatory prerequisite to selecting another estimated audit method, such as the one used herein (*Matter of 33 Virginia Place*, December 23, 2009). The Tribunal has also confirmed the Division's latitude to choose the method it feels best accomplished its goal of reasonably estimating a petitioners' tax liability, and has specifically held that the use of prepaid cigarette tax credits as the basis for estimating sales is a reasonable method, so long as there is more (*Matter of Shree Purshottam Corporation*). Thus, the latitude employed by the Division in choosing this methodology, though executed with errors, did not exceed its authority.

Whether the Division was substantially justified in its position at the time the notices were issued hinges on two key facts of this case: the appropriateness of its decision to estimate due to the absence of books and records and whether the choice of the particular methodology was rational. The Division has already established that it was justified in estimating petitioners' tax liability. Although the Tribunal has previously affirmed that the use of the cigarette credits paid as a basis for estimating sales was rational (*Matter of Shree Purshottam Corporation*), the manner in which the ratio was established was entirely without substantiation yielding an audit methodology that did not result in a reasonable calculation of petitioners' tax liability. Simply, although the use of the cigarette tax credits was acceptable, the manner in which the Division

altered the percentage to derive sales was in error. The Division's additional failure to use common sense when it applied percentages from other sales tax audits, when those percentages had been agreed upon in the context of settlement negotiations also proved fatal to the reasonableness of its results. However, the position that the Division took as to its decision to estimate petitioners' tax liability and the reports so employed to do so was substantially justified. There is no evidence that, when the Division employed the estimated method used in this case, it did so to extract excessive tax revenue from petitioners that was not justified under the circumstances, or for purposes of harassment or embarrassment, or out of political motivation (*see HR Rep 404, 97th Cong*, at 12 [1981]). Nor is there any evidence that the Division's position in this case was inconsistent with the position it has taken in other similar cases. The Tax Court in *Reliable Credit Association, Inc. v. Commr.* (73 TCM 1948 [1997]) similarly denied an award of costs to a corporation that failed to maintain books and records, though required to do so, and affirmed the reasonableness of the IRS's determination of corporate income by any method that clearly reflected income. In responding to that taxpayer's claims that the IRS failed to employ certain auditing procedures that would have enabled it to easily ascertain the correct amount of the deficiencies, the Court stated: "when the taxpayer has defaulted in . . . [its] task of supplying adequate records, . . . [the taxpayer] is not in a position to be hypercritical of the Commissioner's labor." The fact that errors resulted in this case from the way the ratios were established by the auditors simply does not support an award of costs to petitioners. It was petitioners' failure to produce sufficient records that fueled a process they were forced to defend. Petitioners would have been in the same position of challenging the reasonableness of the audit method and its result, regardless of the arbitrary ratios used.

F. Tax Law § 3030(c)(5)(A)(ii) requires the party seeking costs establish that its net worth does not exceed certain statutory limits. Petitioners make no mention, let alone a sworn statement, that such limits are not exceeded. This application for costs, absent such information, is defective for this reason as well.

G. Since a determination has been made that the Division was substantially justified in its position and that the application lacks the necessary net worth information, and thus, petitioners are not entitled to an award of costs, it is unnecessary to determine whether the fees and disbursements claimed are reasonable and substantiated.

H. Petitioners' application for costs and fees is denied.

DATED: Albany, New York
December 20, 2012

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE